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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The Italian Economy: Slow Growth and Clouded Prospects

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1972

INTELLIGENCE MEMORANDUM

THE ITALIAN ECONOMY: SLOW GROWTH AND CLOUDED PROSPECTS

Introduction

1. Italy's 1971 economic slump – the deepest in the postwar period – exacerbated mounting policy differences among center-left parties, heightened intra-governmental tensions, hastened the Colombo government's fall, and influenced President Leone to call the first early elections in the Republic's history. The slump, which shows scattered but ephemeral signs of abating, also has aggravated labor discontent by delaying implementation of widely demanded social reforms. Although the May elections resulted in only a slight shift in the parliamentary strengths of the major parties, a "permanent" government may not be patched together until autumn, after the major parties have sorted out their policies and alignments at party congresses. In the interim a minority coalition or an all Christian-Democrat caretaker government probably will rule. This government and its successor will face difficult economic policy decisions, many of which will affect prospects for labor strife in the extensive union contract negotiations scheduled for fall. This memorandum describes recent economic trends and analyzes the factors behind the economic slowdown. It also discusses the government's hopes and businessmen's expectations for the economy this year, concluding with an assessment of short-term prospects.

Discussion

Background

2. During most of the 1960s, Italy experienced rapid economic growth, with real gross national product (GNP) rising an average of 5.8%

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

a year. Foreign demand was the most dynamic factor in the expansion. Benefiting from the international competitiveness of Italian goods, rising incomes abroad, and the stimulative effects of integration in the European Community, exports increased at an average annual rate of 13%. In response to strong export and domestic consumer demand, investment in plant, equipment, and housing expanded rapidly.

3. After averaging 6% annually in 1967-69, the GNP growth rate dropped to 5% in 1970. This loss of momentum was in large measure attributable to the sharp increases in contractual wages and continued labor strife that followed the "hot autumn" of 1969, when triennial union contracts affecting nearly half the industrial labor force came up for renewal. The attendant disruption of industrial activity and boosts in production costs created a situation that not only led Italian businessmen to postpone investment but also made it increasingly difficult for them to land export orders. Gross fixed investment increased only 3.8% in 1970 after rising at an average annual rate of 9.8% in 1967-69, and the growth of export volume dropped to 7.0% from the 12.1% average of the preceding three years.[1]

4. Occurring at a time when wages were rising steeply (many of the 1969 contracts called for 40% boosts over three years), the frequent disruptions of output slowed the growth of productivity and led to a 14.5% increase in unit labor costs in 1970. These disruptions stemmed from several causes. Plant-level agitation for greater wage and fringe benefits was continuing, and – by the second quarter of the year – major labor confederations were joining in nationwide social-protest strikes. In addition, industrial absenteeism rose to an all-time high, encouraged by a new Workers' Statute that inhibits employers' checking on reported sick leave.

5. With demand faltering and wages pushing up production costs, Italian firms increasingly found their profits squeezed. The resulting reduction of self-financing ability, together with high interest rates and private investors' uncertainty in the face of tumultuous labor relations and the coalition government's shaky prospects, led to a marked slowing of investment in 1970. Housing starts dropped sharply – an ominous sign because construction strongly influences consumer income and expenditure, not only providing a relatively large number of jobs directly but also drawing heavily on ancillary industries for materials.

6. Although Italian exporters cut profit margins to minimize the adverse effects of rising production costs, export prices began to creep

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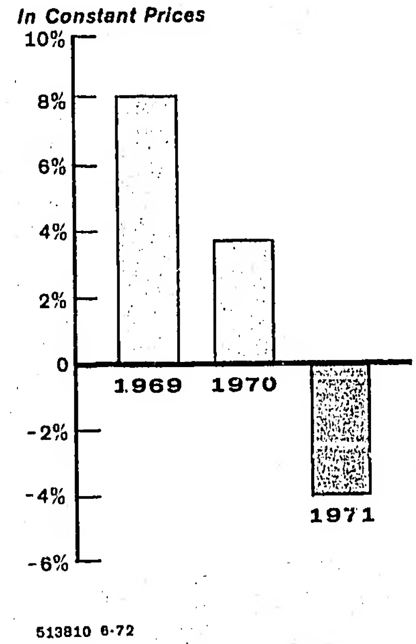
upward in 1970. The competitive effect of the rise in Italian export prices was largely offset by increases in other countries' export prices. Nevertheless, Italy's competitive edge in some important products, such as shoes, deteriorated. Reduced competitiveness and weakening demand in some major markets checked export growth. Moreover, strikes caused supply bottlenecks that delayed filling some export orders and impaired Italian firms' ability to guarantee prompt delivery of new orders.

A Year to Forget: 1971

7. Weak consumer and foreign demand persisted in 1971 and gross fixed investment dropped 4% (see Figure 1), reducing real GNP growth to a meager 1.4%. With wages still rising, growth in productivity low because of production disruptions, and plant utilization continuing to fall (see Figure 2), higher unit labor costs again seriously impaired manufacturing firms' ability to finance investment from retained earnings. The profit squeeze (aggravated by rising prices for imported inputs and the difficulty of boosting selling prices in a soft market), mounting political uncertainties, international monetary confusion, and the still unsettled labor climate made businessmen hesitant to increase investment – particularly if borrowing was necessary.

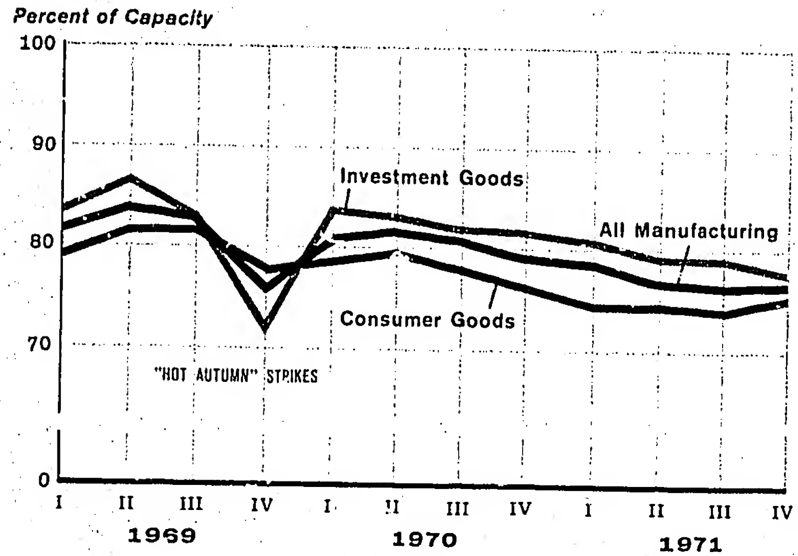
Figure 1

ITALY
Growth of Gross Fixed Investment



8. Supply bottlenecks were less disruptive than in 1969-70 but remained a problem. Because long-promised tax and housing reforms were legislated and the government worked on a national health scheme, there were fewer strikes to protest the inadequate social infrastructure. Notable plant-level disputes still occurred, however, cutting into the output of many firms, including Fiat and Zanussi, that are important employers and exporters. In all, about 100 million man-hours were lost to strikes, compared with 146 million in 1970 and the record 303 million in 1969.

ITALY: Plant Utilization Figure 2



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9. New cuts in the contractual work week and continued heavy absenteeism also constrained growth. Employers hesitated to compensate for these losses by hiring additional workers because of Italy's nearly insurmountable legal barriers to discharging employees.

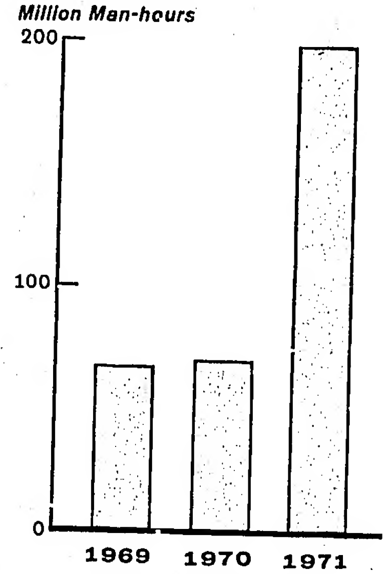
10. Industry was hard hit by the 1971 slump, suffering a 2.7% production decline. The decline was sharp for investment goods – down 4.9% – with machine building suffering a particularly severe decline. Consumer goods output, especially clothing and silk and cotton textiles, also contracted.

11. Slack industrial activity in 1971 led to increased unemployment. The jump was steep for manufacturing; it was less notable for construction, which was already in the doldrums. In late 1971, official unemployment estimates ranged from 3.2% to 5.5% of the labor force, up from 3.1% to 4.6% a year earlier. Cutbacks in output were also reflected in a sharp rise in temporary lay-offs (not counted as unemployment) and an increased number of part-time workers. The full extent of the unemployment rise is suggested by the trebling from 1970 to 1971 in the number of man-hours of unemployment compensation paid by the National Wage Supplement Fund (see Figure 3).

12. One favorable aspect of slack economic activity in 1971 was the slowing of inflation. Despite increases in unit labor costs (up an estimated 12%) and in costs of imported industrial inputs (up about 10%), wholesale prices rose only 2.3%, compared with 5.0% the previous year. The 4.7% rise in the cost-of-living, although substantially above the average of the 1960s, was below that of 1970 and among Western Europe's lowest.

Figure 3

ITALY
Unemployment Compensated by the National Wage Supplement Fund*



*Blue-Collar Workers

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13. Last year's sluggish economic performance resulted in doubling – to $783 million[2] – of Italy's balance-of-payments surplus. This change was primarily the result of an improved trade balance. With domestic demand weak, imports showed much less growth than exports, so that the trade deficit was cut to $920 million – about one-half that of 1970. Exchange rate floats and uncertainties – and finally the currency realignments – had relatively little effect on trade. During most of the second half of 1971, a de facto net global devaluation of the lira of about 2% prevailed, a change not substantial enough to have more than marginal effect. Sizable increments in receipts from tourism and emigrant remittances also contributed substantially to the payments surplus.

Government's Reactions, Plans, and Hopes

14. The center-left Colombo government tried unsuccessfully during 1971 to restore investor confidence and bring about a resurgence of aggregate demand through expansionary monetary and fiscal policies. The discount rate was reduced from 5.5% to 5.0% in April 1971, then to 4.5% in October. Despite this and other measures that contributed to a 20% increase in the money supply in 1971, businessmen remained reluctant to borrow for investment purposes. Judging from the slowness with which

2. Lire values were converted to dollars at the central rate of 581.5 lire = US $1.

interest rates declined, lenders also took a jaundiced view of the risks involved in credit extension. Countercyclical fiscal measures at first concentrated on assistance to two hard-hit industries: textiles and construction. Later, as it became evident that private-sector investment decisions were generally paralyzed by the international monetary turmoil and the domestic political situation, the government concentrated on channeling investment funds through the publicly-owned corporations and boosting direct government outlays.

15. Following dissolution of parliament in February 1972, a prime objective of the Christian-Democrat caretaker government headed by Guilio Andreotti was to generate more rapid economic growth – hopefully with improvement becoming manifest before the May elections. The Andreotti government generally subscribed to the 1972 economic plan prepared under Colombo. It continued monetary ease, and in April reduced the discount rate to 4.0% and transferred more than $800 million to state enterprises to facilitate their investment programs. The plan contains ambitious "programming hypotheses" suggesting that the rate of real growth in 1972 could reach 4.5% or 5.0%.

16. The plan's success hinges largely on an investment revival accompanied by some improvement in consumer spending. The government most likely will follow an expansionary budget policy and attempt to accelerate the channeling of funds (for which most of the necessary appropriations already exist) into productive state investment. It will also try to speed implementation of housing reforms and southern economic development as means of bolstering business confidence and inducing greater private investment. But businessmen's uncertainty as to how the value added tax (VAT) system to be introduced in January 1973 will affect their operations adds to their hesitancy to invest.(3) To stimulate consumer spending, the Andreotti caretaker government – under provisions of a 1969 law – promised to increase pensions for the self-employed. A bill to provide a similar increase in benefits for employees will probably be introduced in the new parliament.

3. The VAT system, by requiring more detailed accounts, is expected to make tax evasion -- Italy's national pastime -- substantially more difficult. Tax evasion has provided firms with large -- if illegal -- subsidies in the past. While ingenious Italian businessmen will surely find a way to continue evading at least a part of their taxes, this source of profits is likely to be reduced under the VAT. [redacted] 25X1

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17. Earlier this year, the government claimed that gross investment could increase to $24.6 billion in 1972, 12% more, in money terms, than last year's capital spending. Available information on projected capital outlays suggests that the government was planning to increase public investment by 17% and counting on a 9% increase in private investment (both in money terms). As shown in the table, projected direct government

Italy: Gross Investment

Million Current US $

	1969	1970	1971	1972[a]
Total	19,178	22,710	21,926	24,590
Public investment	5,125	6,301[b]	8,012[b]	9,375[b]
Direct government investment	1,500	1,788	2,141	2,580
State enterprises	1,601	2,277	3,293	3,637
Electric power agency	846	1,032	1,238	1,495
Other[c]	1,178	1,204[b]	1,340[b]	1,663[b]
Private investment	14,053	16,409[b]	13,914[b]	15,215[b]
Housing	5,926	6,516	6,000[b]	5,800[b]
Other (residual)	8,127	9,893[b]	7,914[b]	9,415[b]

a. Government plan.
b. CIA estimate.
c. Autonomous agencies such as the railroads.

expenditures on public works (such as highway construction) amount to some $2.6 billion, or 21% more than in 1971. Large amounts of these funds are earmarked for development of southern Italy. Of particular significance is the increase, to $3.6 billion, in the amount to be spent indirectly, through state holding companies such as ENI (**Ente Nazionale Idrocarburi**). Because these companies finance investment from profits, borrowing, and transfers from the state budget, they are largely independent of the Italian government's monumental red-tape and thus are considered by the planners more likely than the state ministries to achieve investment goals. Most of the state holding companies' investment for 1972 is planned for the steel, automobile, petrochemical, telecommunications, and

transportation sectors. Altogether, public investment outlays would account for 38% of gross investment, compared with 27% in 1969. Private housing outlays are expected to fall slightly, but the plan projects an increase in other private investment slightly more rapid than that of public investment.

18. The planners do not expect that the projected increases of 4.5% to 5.0% in aggregate demand and 7% in industrial production would raise employment more than slightly. Employers will continue to prefer increasing output through overtime and improved efficiency rather than by hiring additional workers who would be almost impossible to dismiss should they later become redundant.

Short-Term Economic Prospects

19. The deterioration in the growth of output, demand, and employment apparently halted in early 1972. The government, however, has thus far failed to stimulate an upturn – despite mildly expansionary fiscal measures, lowering of interest rates, attempts to speed the release of backlogged public works appropriations, and optimistic statements designed to give a lift to the economy. Scattered indicators have shown transient improvements, but recovery remains elusive. Industrial production is stagnating near the early 1970 level. Chances for a strong private investment revival in the spring were aborted by uncertainties associated with the domestic political situation, continued substantial excess capacity, and a renewed spurt of strikes. Housing in particular has remained weak. Most firms have remained extremely wary of increasing their indebtedness, although there is ample liquidity in the banking system. Bureaucratic difficulties, as usual, have impeded release of government funds despite repeated promises and numerous committee meetings. Although demand remained weak, the rise in wholesale prices and the cost-of-living accelerated somewhat in early 1972, reflecting continued cost increases.

20. Public investment spending should stimulate the economy, but achieving the projected 17% increase is doubtful. Administrative delays in implementing Italian public works projects are notorious. Moreover, with formation of a new coalition government preoccupying political figures, official estimates for hospital, school, and other public works spending must be discounted heavily. Spending on public housing, however, may be an exception. An October 1971 housing reform law aims at reorganizing public housing efforts and increasing low-income public housing construction. Because the low-income housing shortage is so acute and the housing issue so politically sensitive, the new government will undoubtedly press hard for early results in this field. But public housing accounts for only 4% of total housing investment and a minuscule share of gross investment. Hence, even a substantial increase in the state's housing effort would have little impact on aggregate demand.

21. The business community's economic expectations for 1972 are more pessimistic – and probably more realistic – than those of government officials. Most businessmen foresee only a modest improvement in economic conditions, with the growth rate advancing marginally to 2% or so. In general, they agree with the government view that economic recovery must be led by substantial public sector investments, particularly in the South. They are not willing to commit their own funds before there is hard evidence that governmental investment funds are actually flowing into the economy. Their wait-and-see attitude is evidenced by the continuing high degree of bank liquidity. Many firms have lost much of their ability to finance investment from their own funds and fear a protracted period of negotiations to form a new government (not to mention the labor negotiations this fall or the upcoming implementation of broad tax reforms). Small and medium-sized companies, in particular, are not confident enough to increase their indebtedness. With a quarter of productive capacity in manufacturing still unutilized, firms seek stronger assurance that a sustained pickup is under way before turning to large-scale borrowing to finance fixed investment or inventory accumulation. There is, however, little likelihood that profit margins will widen substantially or that business confidence will improve before mid-summer at best, and the stimulative effects of steps already taken to aid private investment could disappear in an atmosphere of political or labor chaos.

22. Much of the gloom in the outlook for private investment is traceable to an expected drop in private housing construction. Housing construction is not only a major component of private investment (about two-fifths) but also a large employer and a significant market for other economic sectors. Issuance of new housing permits stagnated in 1970-71, and actual starts declined in both years. This was partly a consequence of the completion of large numbers of residential structures – mostly luxury housing – started just before introduction of new, harsher building codes in September 1969. Although aids to facilitate low-income private housing mortgages have been enacted, private residential construction will probably drop again in 1972.

23. On balance, gross investment (accounting for about one-fifth of GNP) seems more likely to falter this year than to show the planned sharp upturn, even if the projected increase in total public investment were realized. The large planned gain in total private investment clearly is at variance with the temper of the business community; private investment is more likely to stagnate or decline again than to post a 9% rise. Moreover, a strong upsurge in other components of effective demand is not likely this year. With the economy operating at less than full employment and prospects for increasing employment admittedly small, there is little chance that the rate of increase in private consumer spending (which accounts for

about two-thirds of GNP) will exceed last year's 3% – despite the Andreotti government's politically motivated promises to increase pension scales. Moreover, to help offset the inflationary consequences of planned spending increases for productive investment, the government will probably try to hold the rise in current public consumption items such as government employees' salaries to only about 2%.

24. Exports are unlikely to be a strong expansionary factor this year. Income growth is slow again this year in several of Italy's major foreign markets, and even with some recovery – in West Germany, for example – a strong resurgence of foreign demand for Italy's wares is unlikely. With Italian industry facing continuing difficulty in meeting delivery dates and with the favorable – if marginal – impact of last year's 2% global devaluation of the lira largely negated by inflation, merchandise exports will probably expand at about the same rate as in 1971. Imports can be expected to increase relatively slowly once again because of below-normal economic growth in Italy. Accordingly, the trade balance should remain strong, and the current account in the balance of payments may be expected to record another large surplus.

25. Little change is expected in employment trends. But with wages and import prices continuing their rise, prices may climb somewhat faster than in 1971. After two years of cutting profit margins to absorb rising costs, producers are increasingly likely to hike selling prices as costs rise. Delaying implementation of VAT, however, should hold the inflation below the 8% rate that many feared. The direct and indirect effects of VAT (if introduced in July 1972, as scheduled earlier) had been expected to boost consumer prices by 2% to 3%.

Conclusions

26. The progressive deterioration in the growth of output, demand, and employment seems to have halted, but even a moderately strong economic comeback is unlikely this year. Governmental projections of rapidly accelerating economic growth hinge on unrealistic investment goals. Given the still unsettled governmental situation and the bureaucracy's traditional inertia, the official estimates for public investment spending in 1972 are probably too optimistic. The estimates for private investment, moreover, are clearly out of step with the business community's continuing pessimism. A substantial pickup in private investment is likely only in the improbable event that political uncertainties end soon and strong actions are taken to both ease cost pressures and avoid serious labor unrest this fall. However, even with investment stagnant, Italy could post a 2% to 3% increase in real GNP this year, based largely on a continued – if modest – growth in private and government consumption and utilization of excess productive capacity.